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**REPORT OF THE AUDITOR-GENERAL TO EASTERN CAPE PROVINCIAL  
LEGISLATURE AND THE COUNCIL ON THE FINANCIAL STATEMENTS AND  
PERFORMANCE INFORMATION OF MAKANA MUNICIPALITY FOR THE YEAR  
ENDED 30 JUNE 2009**

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I have audited the accompanying financial statements of the Makana Municipality which comprise the statement of financial position as at 30 June 2009, and the statement of financial performance, the statement of changes in net assets and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, as set out on pages [xx] to [xx].

**The Accounting Officer's responsibility for the financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the Statements of Generally Recognised Accounting Practice (Statements of GRAP) and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) and for such internal control as the accounting officer determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud and error.

**The Auditor-General's responsibility**

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996 read with section 4 of the Public Audit Act, 2004 (Act No. 25 of 2004) (PAA) and section 126(3) of the MFMA, my responsibility is to express an opinion on these financial statements based on my audit.
4. I conducted my audit in accordance with the International Standards on Auditing read with *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008*. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.
5. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

6. Paragraph 11 *et seq.* of the Statement of Generally Recognised Accounting Practice, GRAP 1 *Presentation of Financial Statements* requires that financial reporting by entities shall provide information on whether resources were obtained and used in accordance with the legally adopted budget. As the budget reporting standard is not effective for this financial year, I have determined that my audit of any disclosures made by the Makana Municipality in this respect will be limited to reporting on non-compliance with this disclosure requirement.
7. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

#### **Basis for adverse opinion**

#### **Accumulated Surplus**

8. Prior year expenditure was overstated by R5.6 million and there were material scope limitations on revenue which resulted in a modification of my opinion. These matters were not resolved by the municipality and my opinion on the current period financial statements is also modified because of the possible effect of this matter on the comparability of the current and corresponding period figures.

#### **Trade Payables**

9. The municipality's leave accrual is calculated based on leave days that are in the system as at year end. There was, however no adequate system of control over capturing of leave in the system on which I could rely for the purpose of my audit as employee's leave was not captured timeously. As a result the leave accrual and employee costs are overstated by R2 million.
10. Furthermore, the closing balance of leave days in the prior year could not be confirmed due to inadequate system of control over capturing of leave in the system. My opinion on the financial statements for the period ended 30 June 2008 was modified accordingly. My opinion on the current period financial statements is also modified because of the possible effect of this matter on the comparability of the current and corresponding figures.
11. Included in trade payables is a balance of R1.4 million for trade creditors. Adequate documentation in support of these trade creditors could not be provided. Furthermore journals to the value of R1.9 million were processed to the creditor's ledger without adequate supporting documentation. As a result, trade payables as disclosed in the statement of financial position and note 7 to the financial statements are overstated by R3.3 million and expenditure is overstated by the same amount.

#### **Taxes**

12. The municipality did not claim VAT input on all expenditure incurred during the year. As a result, Taxes as disclosed in the statement of financial position and in note 9 to the financial statements and expenditure are overstated by R1.6 million.

### **Investment Property**

13. GRAP 16 par. 10 (b) states that land held for a currently undetermined future use should be recognized as Investment Property. The municipality has classified land as Property, Plant and Equipment instead of classifying it as investment property as required by GRAP 16.

### **Cash and Cash Equivalents**

14. The operational bank account did not reconcile to the amount disclosed in the financial statements. The bank balance per the bank statement and bank confirmation was R3.7 million and balance per financial statements was R12.3 million (overdraft). This resulted in a difference of R16.1 million that could not be explained by the municipality.
15. In the bank reconciliation, the bank account balance per general ledger was stated as R22.7 million (overdraft) instead of R12.3 million (overdraft) resulting in a difference of R10.4 million and no explanation of this difference was provided by the municipality. Furthermore the municipality could not provide supporting documentation for the reconciling items in the bank reconciliation amounting to R26 million.
16. The municipality's accounting records did not permit the application of alternative audit procedures as supporting documentation for reconciling differences was not made available. I was furthermore, unable to obtain the representations considered necessary from management with respect to these reconciling differences.
17. As a result, I was unable to obtain sufficient appropriate evidence that cash and cash equivalents disclosed on the Statement of financial position and note 20 to the financial statements is correct.
18. Furthermore, journals to the value of R2.1 million were processed to the bank account without adequate supporting documentation thus resulting in understatement of cash and cash equivalents by R2.1 million and overstatement of trade payables by the same amount.

### **Receivables**

19. The debtors listing does not agree to the amount as disclosed in the financial statements by an amount of R1.4 million. I could not be provided with the proper explanation and adequate supporting documentation for this difference. As a result receivables and revenue are overstated by R1.4 million.
20. Long outstanding debtors that are not traceable or recoverable are not written off by the municipality. Furthermore debtors written off per council approval were understated. As a result, receivables are overstated by R1.9 million and bad debts are understated by the same amount.

### **Revenue**

21. The detailed annual or monthly billing reports could not be provided by the municipality to support transactions that were processed in the general ledger relating to service charges.
22. The municipality's accounting records did not permit the application of alternative audit procedures. As a result, I was unable to obtain sufficient appropriate evidence that service charges revenue disclosed on the Statement of financial performance is correct.

23. Supporting documentation could not be obtained for the other revenue recorded in the financial statements resulting in overstatement of other revenue and receivables by R 2.1 million.
24. The municipality did not obtain approval for electricity tariffs used in the current financial year as required by National Electricity Regulator. As a result, electricity revenue and receivables is overstated by R1.7 million.
25. Furthermore, the municipality did not disclose its revenue at fair value as per the requirements of IFRS 7 and IAS 39 (Financial Instruments), as a result property rates and service charges revenue is overstated by R7.5 million (2008: R6 million) and interest is understated by the same amount.

#### **Adverse opinion**

26. In my opinion, because of the significance of the matters described in the basis for adverse opinion paragraphs, the financial statements do not present fairly the financial position of the Makana Municipality as at 30 June 2009 and its financial performance and cash flows for the year then ended, in accordance with statements of Generally Recognised Accounting Practice (Statements of GRAP) and in the manner required by the MFMA.

#### **Emphasis of matter**

I draw attention to the following matters on which I do not express an adverse opinion:

#### **Unauthorised expenditure**

27. Unauthorized expenditure to the amount of R59.3 million is disclosed in note 37.1 to the annual financial statements. The unauthorised expenditure arose from over expenditure of approved budget.

#### **Irregular expenditure**

28. Irregular expenditure to the amount of R2.1 million is disclosed in note 37.8 to the annual financial statements. The irregular expenditure arose from non compliance to the Supply Chains Management Regulation.

#### **OTHER MATTERS**

I draw attention to the following matters that are ancillary to my responsibilities in the audit of the financial statements:

#### **Unaudited supplementary schedules**

29. The supplementary information set out on pages xx to xx does not form part of the financial statements and are presented as additional information. I have not audited these schedules and accordingly I do not express an opinion thereon.

#### **Material non-compliance with applicable legislation**

30. Supply Chain Management Regulation 26-29, states that the municipality is required to have a bid specification committee, bid evaluation committee and

bid adjudication committee. There was none of these committees until the last quarter of the year.

31. Section 65 2(e) of the MFMA states that the accounting officer must take all reasonable steps to ensure that all money owing by the municipality is paid within 30 days of receiving the relevant invoice or statement, unless prescribed otherwise for certain categories of expenditure. The municipality did not pay an amount of R2 million to its suppliers within 30 days as prescribed by this section.
32. Section 79 (1) (c) of the MFMA states that the accounting officer of a municipality must regularly review delegations issued in terms of paragraph (b) of Section 79 (1) and, if necessary, amend or withdraw any of those delegations. Delegations issued by the Mayor have not been reviewed since 2002.
33. Section 131 (1) of MFMA, states that the municipality must address any issues raised by the Auditor General in the audit report. In our performance of the current year audit, we have identified that some prior year issues raised by Auditor General have not been addressed during the current year.
34. The municipality did not comply with Section 126(2) of the MFMA, which requires that financial statements be submitted within two months after the financial year end.
35. Section 125(2) (e) of the MFMA, states that the municipality is required to disclose all instances of non compliance with MFMA in the financial statements. No disclosure in the financial statements is provided for all instances of non compliance with MFMA identified above.

#### **Governance framework**

36. The governance principles that impact the auditor's opinion on the financial statements are related to the responsibilities and practices exercised by the accounting officer and executive management and are reflected in the internal control deficiencies and key governance responsibilities addressed below:

#### **Internal control deficiencies**

37. Section 62(1)(c)(i) of the MFMA states that the accounting officer must ensure that the Municipality has and maintains effective, efficient and transparent systems of financial and risk management and internal control. The table below depicts the root causes that gave rise to the deficiencies in the system of internal control, which led to the adverse of opinion. The root causes are categorised according to the five components of an effective system of internal control. (The number listed per component can be followed with the legend below the table.) In some instances deficiencies exist in more than one internal control component.

Par. No.	Basis for disclaimer of opinion	CE	RA	CA	IC	M
8	Accumulated Surplus	6				
9 -11	Trade Payables			3		
12	Taxes			3		
13	Investment Property			3		

14-18	Cash and cash equivalent			6		
19-20	Receivables			6		
21-25	Revenue			2		

38. There were overall weaknesses in the control environment and control activities within the municipality. Management did not ensure that adequate controls are implemented and adhered to and that any breakdown in internal control is identified and corrected timeously.

<b>Legend</b>	
<b>CE = Control environment</b>	
The organisational structure does not address areas of responsibility and lines of reporting to support effective control over financial reporting.	1
Management and staff are not assigned appropriate levels of authority and responsibility to facilitate control over financial reporting.	2
Human resource policies do not facilitate effective recruitment and training, disciplining and supervision of personnel.	3
Integrity and ethical values have not been developed and are not understood to set the standard for financial reporting.	4
The accounting officer/accounting authority does not exercise oversight responsibility over financial reporting and internal control.	5
Management's philosophy and operating style do not promote effective control over financial reporting.	6
The entity does not have individuals competent in financial reporting and related matters.	7
<b>RA = Risk assessment</b>	
Management has not specified financial reporting objectives to enable the identification of risks to reliable financial reporting.	1
The entity does not identify risks to the achievement of financial reporting objectives.	2
The entity does not analyse the likelihood and impact of the risks identified.	3
The entity does not determine a risk strategy/action plan to manage identified risks.	4
The potential for material misstatement due to fraud is not considered.	5
<b>CA = Control activities</b>	
There is inadequate segregation of duties to prevent fraudulent data and asset misappropriation.	1
General information technology controls have not been designed to maintain the integrity of the information system and the security of the data.	2
Manual or automated controls are not designed to ensure that the transactions have occurred, are authorised, and are completely and accurately processed.	3
Actions are not taken to address risks to the achievement of financial reporting objectives.	4
Control activities are not selected and developed to mitigate risks over financial reporting.	5
Policies and procedures related to financial reporting are not established and communicated.	6
Realistic targets are not set for financial performance measures, which are in turn not linked to an effective reward system.	7
<b>IC = Information and communication</b>	
Pertinent information is not identified and captured in a form and time frame to support financial reporting.	1
Information required to implement internal control is not available to personnel to enable internal control responsibilities.	2
Communications do not enable and support the understanding and execution of internal control processes and responsibilities by personnel.	3
<b>M = Monitoring</b>	
Ongoing monitoring and supervision are not undertaken to enable an assessment of the effectiveness of internal control over financial reporting.	1
Neither reviews by internal audit or the audit committee nor self-assessments are evident.	2
Internal control deficiencies are not identified and communicated in a timely manner to allow for corrective action to be taken.	3

### **Key governance responsibilities**

39. The MFMA tasks the accounting officer with a number of responsibilities concerning financial and risk management and internal control. Fundamental to achieving this is the implementation of key governance responsibilities, which I have assessed as follows:

No	Matter	Y	N
<b>Clear trail of supporting documentation that is easily available and provided in a timely manner</b>			
1.	No significant difficulties were experienced during the audit concerning delays or the availability of requested information.		x
<b>Quality of financial statements and related management information</b>			
2.	The financial statements were not subject to any material amendments resulting from the audit.		x
3.	The annual report was submitted for consideration prior to the tabling of the auditor's report.	x	
<b>Timeliness of financial statements and management information</b>			
4.	The annual financial statements were submitted for auditing as per the legislated deadlines section 126 of the MFMA.		x
<b>Availability of key officials during audit</b>			
5.	Key officials were available throughout the audit process.	x	
<b>Development and compliance with risk management, effective internal control and governance practices</b>			
6.	Audit committee		
	• The Municipality had an audit committee in operation throughout the financial year.	x	
	• The audit committee operates in accordance with approved, written terms of reference.	x	
	• The audit committee substantially fulfilled its responsibilities for the year, as set out in section 166(2) of the MFMA.		x
7.	Internal audit		
	• The Municipality had an internal audit function in operation throughout the financial year.	x	
	• The Municipality had an internal audit function in operation throughout the	x	

No	Matter	Y	N
	financial year.		
	<ul style="list-style-type: none"> <li>The internal audit function operates in terms of an approved internal audit plan.</li> </ul>	X	
	<ul style="list-style-type: none"> <li>The internal audit function substantially fulfilled its responsibilities for the year, as set out in section 165(2) of the MFMA.</li> </ul>	X	
8.	There are no significant deficiencies in the design and implementation of internal control in respect of financial and risk management.	x	
9.	There are no significant deficiencies in the design and implementation of internal control in respect of compliance with applicable laws and regulations.	x	
10.	The information systems were appropriate to facilitate the preparation of the financial statements.	x	
11.	A risk assessment was conducted on a regular basis and a risk management strategy, which includes a fraud prevention plan, is documented and used as set out in section 95(c)(i) of the MFMA.	X	
12.	Delegations of responsibility are in place, as set out in section 106 of the MFMA.	X	
<b>Follow-up audit findings</b>			
13.	The prior year audit findings have been substantially addressed.	X	
<b>Issues relating to the reporting of performance information</b>			
14.	The information systems were appropriate to facilitate the preparation of a performance report that is accurate and complete.	X	
15.	Adequate control processes and procedures are designed and implemented to ensure the accuracy and completeness of reported performance information.	X	
16.	A strategic plan was prepared and approved for the financial year under review for purposes of monitoring the performance in relation to the budget and delivery by the Makana Municipality against its mandate, predetermined objectives, outputs, indicators and targets in terms of section 87 of the MFMA.	X	
17.	There is a functioning performance management system and performance bonuses are only paid after proper assessment and approval by those charged with governance.	X	

40. Delays were experienced during the execution of our audit as a result of the Municipality not providing some of the documentation and explanations timeously. These were only submitted after the agreed due date of submission. This was due to inadequate systems, monitoring and supervision in place throughout the financial year.
41. The financial statements were subject to material amendments resulting from the audit. This was mainly due to incorrect management estimates relating to provision for bad debts and the incorrect application of GRAP relating to Property, Plant and Equipment Directive 4 exemption.
42. The Municipality did not submit their annual financial statements on the due date. The reason for the late submission was the inability of management to prepare the asset register and bank reconciliation timeously.
43. The Audit Committee did not meet prior to the submission of the financial statements for the year ended 30 June 2009 for auditing, to review their adequacy, reliability and accuracy.
44. The significant deficiencies in the design and implementation of internal control in respect of financial and risk management were attributed to a lack of approved and implemented policies being in place for the whole year under review and to key internal controls and processes that were either not in place or not functioning as intended.
45. The significant deficiencies in the design and implementation of internal control in respect of the compliance with applicable laws and regulations were attributed to a lack of implemented controls not being adhered to and a lack of monitoring and supervision by management.
46. The municipality does not have reliable information systems for recording and reporting of financial information. We have also encountered significant problems with the system during the audit as it couldn't produce the required information in the format that would enable efficient audit process. Also the systems in use is not user friendly to municipal staff and the municipality had to rely heavily on consultants which are not locally based to operate the system.
47. Management had an audit intervention plan in place to address prior year finding, however these plans were not adequately implemented because most of the prior year findings were still recurring in the current year.
48. The municipality does not have adequate system in place to ensure that reported performance information is accurate and reliable. As a result sufficient appropriate audit evidence with regard to the reported performance information of the Housing and Infrastructure programme could not be obtained. The following discrepancies were noted:
  - The actual information reported at year end relates to information that was collected a month after year end and,
  - The IDP unit responsible for compiling the performance report does not review information received from other directorates to ensure accuracy, validity and completeness of such information.
49. There are no documented and approved policies and procedures in place for the reporting of performance information.

## **REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS**

### **Report on performance information**

50. I was engaged to review the performance information.

### **The accounting officer's responsibility for the performance information**

51. In terms of section 121(3)(c) of the MFMA, the annual report of a municipality must include the annual performance report of the municipality, prepared by the municipality in terms of section 46 of the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000) (MSA).

### **The Auditor-General's responsibility**

52. I conducted my engagement in accordance with section 13 of the PAA read with *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008* and read in conjunction with section 45 of the Municipal Systems Act, No. 32 of 2000.
53. In terms of the foregoing my engagement included performing procedures of an audit nature to obtain sufficient appropriate evidence about the performance information and related systems, processes and procedures. The procedures selected depend on the auditor's judgement.
54. I believe that the evidence I have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

### **Audit findings**

#### **Non compliance with regulatory requirements**

##### **Non compliance with Municipal Systems Act, 2000**

55. The municipality did not give notice to the public for the adoption of the IDP and the local community was not allowed to provide comments on the draft IDP as required by Section 25 (4) of the MSA.
56. No targets were included in the SDBIP for each quarter as required by MSA, 2000 (Act No. 32 of 2000), Regulation 12(1) and (2) (a-e).
57. The municipality did not include targets that measure efficiency, effectiveness, quality and impact of the performance of the municipality that is consistent with the municipality's development priorities and objectives set out in its KPI's.
58. Performance management system must be adopted before or at the same time as the commencement by the municipality of the process of setting KPI's. The municipality did not comply with Regulation 8 of the MSA.
59. The performance management system (PMS) was not in existence during the setting of KPI's and targets in the IDP. It was only adopted on 12 December 2008, therefore the municipality did not comply with Regulation 8 of the MSA.

60. The existence of input, output and outcome indicators and the link to the development priorities and objectives is not clearly indicated in the IDP as required by Regulation 9(1)(a) of the MSA.
61. A copy of an integrated development plan as adopted by the council of the municipality and any subsequent amendment to the plan was not submitted to the MEC for the local government in the province within 10 days of the adoption or amendment of the plan as required by Section 32 of the MSA.

**Non compliance with Municipal Finance Management Act (MFMA), No 56 of 2003**

62. There was no evidence that the municipality's service delivery and budget implementation plan was approved by the mayor within 28 days after the approval of the budget as required by Section 53(1)(c)(ii) of the MFMA.

**Lack of effective, efficient and transparent systems and internal controls regarding performance management**

63. The accounting officer did not ensure that the municipality has and maintains an effective, efficient and transparent system of internal controls regarding performance management, which describe and represent how the institution's processes of performance planning, monitoring, measurement, review and reporting will be conducted, organised and managed, as required in terms of section 41(1) (a) of the Municipal System Act.

**Content of integrated development plan**

64. The integrated development plan of the municipality did not include the key performance indicators and performance targets determined in terms of its performance management system, as required by sections 26(i) and 41(1)(b) of the MSA and regulation 12 of the Municipal Planning and Performance Management Regulations, 2001.
65. The IDP did not include an identification of communities which do not have access to basic municipal services. The complete organogram required for the implementation of IDP is not included; therefore the municipality's transformation needs are not addressed. It only includes the organogram for the Finance Directorate.
66. The IDP does not include Key Performance Indicators (KPI's) and targets for the following key development priorities.
  - Bulk Water Supply;
  - Safe, reliable and accessible electricity;
  - Construction of Roads and Street Lights;
  - Eradication of backlog in housing; and
  - Construction and renovation of low cost housing

**Usefulness and reliability of reported performance information**

67. The following criteria were used to assess the usefulness and reliability of the information on the municipality's performance with respect to the objectives in its integrated development plan:

- Consistency: Has the municipality reported on its performance with regard to its objectives, indicators and targets in its approved integrated development plan?
- Relevance: Is the performance information as reflected in the indicators and targets clearly linked to the predetermined objectives and mandate. Is this specific and measurable, and is the time period or deadline for delivery specified?
- Reliability: Can the reported performance information be traced back to the source data or documentation and is the reported performance information accurate and complete in relation to the source data or documentation?

The following audit findings relate to the above criteria:

#### **Consistency**

68. The Municipality included Construction and renovation of low cost housing as development priority in annual performance report however the municipality has omitted this development priority on the IDP and SDBIP and no explanation was provided by management for such discrepancies.
69. The IDP unit responsible for compiling the performance report does not review information received from other directorates to ensure accuracy, validity, completeness and consistency of such information.

#### **Relevance**

70. The IDP of the municipality is not presented systematically and as a result, it is not easy to locate information from the IDP document.
71. There are no corrective measures to improve the actual performance disclosed in the performance information report, where the municipality has not achieved the set target.

#### **Reliability**

72. Sufficient and reliable audit evidence with regard to the reported performance information of the Housing and Infrastructure programme could not be obtained as indicated in par. 47.
73. The layout of the annual performance information report is not simple and it is not presented in manner in which the user of such report can understand.

#### **APPRECIATION**

74. The assistance rendered by the staff of the Makana Municipality during the audit is sincerely appreciated.

East London

27 January 2010



*Auditing to build public confidence*